No. 15,890

In the United States Court of Appeals for the Ninth Circuit

N. Gordon Phillips and Lauretta M. Phillips,
petitioners

v.

Commissioner of Internal Revenue, respondent

On Petition for Review of the Decisions of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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CITATIONS

Cases:

13-16.) The Commissioner filed answers (R. 12-13, 16-18) and a hearing was held on June 5, 1957 (R. 22-36). The decisions of the Tax Court sustaining the deficiency were entered on October 16, 1957. (R. 44-45.) Petition for review by this Court was timely filed on January 9, 1958. (R. 45-47.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Did the Tax Court err in holding that taxpayer realized taxable income upon his reported sale of certain stock in 1951 despite the fact that he became obliged to refund the proceeds thereof to a claimant in 1953?

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> Sec. 22. Gross Income.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
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> * * * *
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> (26 U.S.C. 1952 ed., Sec. 22.)

SEC. 42 [As amended by Section 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(a)-1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

* * * *

Sec. 29.42-1. *When Included in Gross Income.*—(a) *In general.*—Except as otherwise provided in section 42, gains, profits and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See sections 29.41-1 to 29.41-3, inclusive.) * * *

* * * *

STATEMENT

The pertinent facts, as stipulated (R. 18-22) and found (R. 38-40), appear as follows:

N. Gordon Phillips (hereinafter called the taxpayer) and Lauretta M. Phillips are husband and wife, residing in Beverly Hills, California. They filed a joint income tax return for 1951 with the then Collector of Internal Revenue for the Sixth District of California at Los Angeles, California. The wife is only interested in the case by virtue of the community property laws of California and her liability under the joint income tax return for 1951. (R. 38.)

The taxpayer organized and promoted the Gordon Oil Company, a California corporation organized on January 30, 1949. For his services and for the transfer of certain leasehold interests, he was to receive one-half of the stock of the company. A permit was issued by the Corporation Commissioner for the State of California in March 1949, authorizing the issuance of 13,000 shares of stock to the taxpayer and the sale of an additional 13,000 shares at a par value of $10, and providing that all shares should be held in escrow and that the taxpayer should receive no dividends on his shares until the purchasers of shares for cash had been reimbursed for the full purchase price. (R. 38.)

The taxpayer (R. 20-21) sold 1,790 shares of stock to other parties, and in March of 1949 the Corporation Commissioner consented to the transfer of the 1,790 shares within escrow to the names of such purchasers. In August 1949 a written instrument (R. 20) was executed by the taxpayer and G. W. Raichart

under the terms of which the taxpayer purportedly agreed to give "For promotional services rendered", when received by the taxpayer from escrow, 320 shares of the capital stock of the Gordon Oil Company (R. 38-39).

G. W. Raichart died on December 27, 1950, and shortly thereafter the taxpayer put through a transaction with a man named Kline wherein the latter agreed to purchase all of the stock of the Gordon Oil Company. On March 21, 1951, the taxpayer received 11,210 shares out of escrow (13,000 shares less 1,790 shares previously transferred) and on or about the same date sold them to Kline for $1,689,347. In August 1951 the Gordon Oil Company was dissolved, thereby extinguishing all of its outstanding shares. (R. 39.)

The taxpayer treated all of the shares of stock and the proceeds received from the sale of stock as his own, reporting the gain from the sale on his 1951 income tax return. (R. 39.)

In February 1952 the widow of G. W. Raichart, as executrix of his will, brought an action in the Superior Court of California against the taxpayer for breach of contract and for conversion with respect to the 320 shares of stock which was the subject of the aforementioned instrument executed by the taxpayer and Raichart. The taxpayer resisted the claim, asserting that the instrument executed by him and Raichart was never intended to be an agreement and was void; that it was executed without consideration; and in the alternative that the written agreement had been canceled and extinguished by an

oral agreement between the parties. In December 1952 the Superior Court rendered a decision and judgment in favor of the plaintiff holding the defendant in that action, the taxpayer here, was guilty of conversion of 320 shares of the Gordon Oil Company stock. Since the stock had been disposed of a money judgment was awarded the plaintiff in that action. The District Court of Appeals, Fourth District of California, affirmed the judgment and an appeal to the Supreme Court of California was denied. The taxpayer paid the judgment, together with interest, in the amount of $56,755.73 in 1953. (R. 39-40.)

In his 1953 return Phillips did not claim a deduction for the payment of the judgment. In 1953 his operations, without regard to the payment of the judgment, resulted in a loss and he had no taxable net income for that year. (R. 40.)

The deficiencies set forth in the statutory notices were due to the reduction in the basis of the 11,210 shares of Gordon Oil Company stock sold and reported by the taxpayer. The taxpayer did not contest this reduction in basis but contended that he was entitled to reduce the sales proceeds reported in his 1951 return by the amount of money received for the 320 shares of stock, which money he was obliged to refund in 1953, pursuant to the judgment of the California Courts. (R. 40.)

The Commissioner contended that the proceeds were received by the taxpayer under a claim of right without restriction as to their disposition, and they were taxable to the taxpayer in 1951, the year they were received and retained even though in a later

year, in 1953, the taxpayer was obliged to refund them. (R. 40-41.)

The Tax Court concluded (R. 41) that "The facts of this case bring it clearly within the claim of right doctrine" and held (R. 41) that "the portion of the proceeds received from the sale of the 320 shares in 1951 was taxable income to the petitioner in that year even though he was later obliged to return the portion of the proceeds received from such sale."

SUMMARY OF ARGUMENT

The Tax Court correctly held, under the facts here obtaining, that the taxpayer realized taxable income in 1951, upon his sale of 320 shares of stock. On August 18, 1949, while the California Corporation Commissioner was requiring all of the Gordon Oil Company stock to be held in escrow, taxpayer privately contracted to turn over 320 shares to one Raichart "For promotional services rendered." On December 27, 1950, Raichart died. On March 21, 1951, the Corporation Commissioner released the stock from escrow and taxpayer sold all of the shares, including the 320 here in issue, to a third party purchaser of the newly organized corporation. The taxpayer treated the sales proceeds as his own and reported the gain from the sale on his 1951 income tax return. In 1952, Raichart's estate sued the taxpayer in the California Superior Court for breach of contract and conversion with respect to the 320 shares which constituted the subject matter of the August 18, 1949, agreement. The taxpayer vigorously defended this suit, claiming that the agreement with

Raichart was invalid. In 1953, after the Superior Court's judgment in favor of Raichart's estate had been affirmed, with appeal denied, the taxpayer paid the judgment. Relying on the state court's determination that the shares belonged to Raichart, he is here asserting that he was not taxable on the gain which arose, in 1951, on his sale of the 320 shares.

Clearly, as the Tax Court held, since the taxpayer received the sales proceeds in 1951 under claim of right without restriction as to their immediate use, he was, in law, properly taxable on the gain in the year of sale regardless of any infirmity in his title and despite the fact that he was obliged to refund the proceeds of such sale two years later. At the time of his receipt and sale of the stock, the lawful restriction of the escrow had been removed by the California Corporation Commissioner, thus freeing him to sell the shares as his own, which, in point of fact, he did. Under the well established federal tax principle requiring the filing of annual returns, the taxpayer was required to report the gain in 1951, the year in which his receipt of the sales proceeds without restriction as to use made the revenue ascertainable. Accordingly, within the clearly applicable "claim of right" rule, the taxpayer, under the established facts, realized income, in 1951, within the meaning of Section 22(a) of the 1939 Code. At the time of the sale, no restriction on taxpayer's immediate use of the proceeds was in existence. At most, there had been a breach of a private contract which, of itself, is not sufficient to postpone the realization of income. Moreover, when the subsequent suit was

brought, alleging the breach, the taxpayer vigorously asserted his claim to the sales proceeds throughout the various stages of the state court litigation. Not until the adverse judgment was affirmed, with appeal denied, did he recognize the validity of the estate's claim and pay over the sale proceeds, thus making an offsetting deduction possible in 1953. Again, the fact that the subsequent year's income might not be sufficient to permit tax benefit, deduction-wise, will not serve to disturb the realization of the income in the earlier year. Under Section 22(a), the equitable considerations, which cannot emerge in focus until the subsequent year, necessarily must give way to the annual accounting requirement that income must be reported in the year of realization—*viz.*, 1951.

Finally, no merit attaches to the taxpayer's contentions raised against the clear applicability of the "claim of right" principle to the here established facts. No serious attempt is made, on this score, to relate the various contentions to these facts. Within the clear meaning of the Supreme Court's pronouncements in *United States* v. *Lewis*, 340 U.S. 590, the final state court determination as to ownership of the 320 shares will not deprive the "claim of right" principle from applying, under these facts, to result in the realization of 1951 income, within the meaning of Section 22(a). Neither do the taxpayer's allegations of a constructive trust, a bailment, or a debtor-creditor relationship between the parties to the August 18, 1949, agreement serve to prevent the immediate realization of income by reason of the sale by the taxpayer in 1951. Neither can the tax-

payer's attempted analogy to *Commissioner* v. *Wilcox*, 327 U.S. 404, serve to blur the bona fides of his consistently asserted claim of right which he vigorously defended throughout the earlier civil litigation in California and here, quite inconsistently, attempts to disavow. Actually, the transactional treatment which the taxpayer seeks can only here be achieved by disregarding the uncontroverted facts, which clearly evidence his realization of income in 1951 within the ambit of both the annual accounting principle and the well established "claim of right" doctrine.

ARGUMENT

Under The Facts Here Obtain~~ed~~ing The Tax Court Correctly Held That, Within The Meaning Of Section 22(a) Of The Internal Revenue Code Of 1939, Taxpayer Realized Taxable Income In 1951 Upon The Sale In That Year Of The 320 Shares Of Stock, Irrespective Of The Fact That He Later Became Obligated To Pay Over The Sales Proceeds By Reason Of A Judgment Entered Against Him In 1953

The Tax Court was correct in holding (R. 41), under the facts here obtaining, that the taxpayer realized taxable income in 1951, upon his sale (R. 20, 39) of the Gordon Oil Company shares to Kline on or about March 21st of that year. As the taxpayer flatly admitted, on cross-examination (R. 31), and as the Tax Court found (R. 39), the taxpayer treated all of the shares and the proceeds received from the sale *as his own* and reported all gain from the sale on his 1951 tax return. Moreover, in February, 1952, when C. W. Raichart's widow brought a breach of contract and conversion action against the tax-

payer in the California Superior Court (R. 39), the taxpayer, in what his own counsel described (R. 25) as "a hotly contested action" based on the purported agreement of August 18, 1949 (R. 20), denied * the validity of any claim by Raichart's estate to 320 shares "For promotional services rendered" (R. 20, 38-39). Only after the California Superior Court's judgment was affirmed, with appeal denied, did the taxpayer pay over the claimed amount, in 1953. (R. 41-42.)

Under these facts, since the taxpayer retained the proceeds of the 1951 sale of the 320 shares under claim of right without restriction as to the disposition of such proceeds, the law is clear that he was properly taxable in the year of sale, regardless of any infirmity in his title and despite the fact that he was obliged to refund the proceeds of such sale, in 1953. *North American Oil* v. *Burnet*, 286 U.S. 417; *United States* v. *Lewis*, 340 U.S. 590; *Healy* v. *Commissioner*, 345 U.S. 278; *Rutkin* v. *United States*, 343 U.S. 130; *Phillips* v. *Commissioner*, 25 T.C. 767, affirmed, 238 F. 2d 473 (C.A. 7th). The legal prin-

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* See *Raichart* v. *Phillips*, 120 C.A. 2d 645, 261 P. 2d 777, where the court stated (p. 651):

> The appellant contends that this agreement was not supported by any consideration, arguing that since all the stock of the corporation was sold prior to the execution of the contract there could be no promotional services for Raichart to perform thereafter; that a past consideration would not be sufficient in the absence of a preexisting legal obligation; and that there is no evidence that the loans previously made to Phillips by Raichart had anything to do with the making of the agreement in question.

ciple, which "is now deeply rooted in the federal tax system" (*United States* v. *Lewis*, *supra*, p. 592), was stated by the Supreme Court in the *North American Oil* case, *supra*, as follows (p. 424):

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

Equally applicable, under these circumstances, is the established corollary federal tax principle requring annual returns, with the tax being payable in the year—*viz.*, 1951—in which the receipt of the sales proceeds without restriction as to their use made the revenue ascertainable. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359. Under this principle, income is properly determined at the close of the taxable year, without regard to the effect of subsequent events. *Penn* v. *Robertson*, 115 F. 2d 167 (C.A. 4th). As the court stated in *National City Bank of New York* v. *Helvering*, 98 F. 2d 93, 96 (C.A. 2d):

> It would be intolerable that the tax must be assessed against both the putative tortfeasor and the claimant; collection of the revenue cannot be delayed, nor should the Treasury be compelled to decide when a possessor's claims are without legal warrant. If he holds with claim of right, he should be taxable as an owner, regardless of any infirmity of his title; * * *

See also *United States* v. *Lesoine*, 203 F. 2d 123 (C.A. 9th), where this Court, rejecting a construc-

tive trust contention by taxpayer, stated (p. 126):

> It is unnecessary to decide whether the taxpayers had the right to retain the dividend under state law or whether they might have been adjudged liable to return it if an action had been brought against them for that purpose. It is plain that the taxpayers received and retained the dividend under a claim of right thereto during the taxable year 1942. The case falls within the familiar "claim of right" doctrine.

See also *Healy* v. *Commissioner*, 345 U.S. 278, 282-283. Manifestly, it would be difficult to devise a set of facts which could more compellingly demonstrate the correctness of the Tax Court's holding that the taxpayer's retention of the 1951 sales proceeds under claim of right, with no restriction as to immediate use, constituted the realization of income in that year, irrespective of any subsequent obligation which might arise to refund such proceeds in 1953.

Just as clearly, there is no merit in the taxpayer's contentions (Br. 9-22) to the contrary. His first contention (Br. 9-10) purports to rely on *Estate of Bluestein* v. *Commissioner*, 15 T.C. 770, as authority for the here irrelevant proposition that gain realized from the 1951 sale of the 320 shares should, under the state court decision in *Raichart* v. *Phillips*, *supra*, be taxable to the Estate of Raichart, as owner, and not to taxpayer. Incident to this contention (Br. 10) is the allegation that the taxpayer received the sales proceeds as a constructive trustee. For a combination of independently controlling reasons, the contention is erroneous. In the first place, it may be observed that, unlike *Bluestein*, which was primarily an estate

tax case, involving, collaterally, the includibility of income in both the decedent's final return and that filed by the executor for the period of administration, the instant case presents only the simple "claim of right" issue as to whether the taxpayer, as the only party before the Court, realized income, within the meaning of Section 22(a) of the 1939 Code, *supra*, on his 1951 sale of the stock in issue. Secondly, it is pertinent that the Tax Court's controlling estate tax determination, in *Bluestein*, as to includible assets, was stated (p. 783) to turn on recognition of an earlier state court determination of asset ownership under the express authority of *Freuler* v. *Helvering*, 291 U.S. 35. The *Bluestein* case was decided by the Tax Court on December 4, 1950. That the expressed reliance on *Freuler*, with respect to according controlling weight to a state court's determination of property rights, does not extend to a "claim of right" issue arising under Section 22(a) of the 1939 Code is made clear by the Supreme Court's subsequent decision in *United States* v. *Lewis*, *supra*, which was handed down on March 26, 1951. There, after quoting Mr. Justice Brandis' familiar statement of the "claim of right" doctrine, initially laid down in *North American Oil* v. *Burnet*, *supra*, the Court stated (p. 591):

> Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim. Nor has the "claim of right" doctrine been impaired, as the Court of Claims stated, by *Freuler* v. *Helvering*, 291 U.S. 35, or *Commissioner* v. *Wilcox*, 327 U.S. 404. The *Freuler* case involved an entirely dif-

ferent section of the Internal Revenue Code, and its holding is inapplicable here.

Again, the taxpayer cannot circumvent his realization of income in 1951 by alleging (Br. 12) that he received the sales proceeds in that year as a constructive trustee. Where, as here, the facts satisfy the "claim of right" rule for realization of income, it is well established that the constructive trust rationale is inapplicable. *United States* v. *Lesoine*, 203 F. 2d 123, 126-127 (C.A. 9th); *St. Regis Paper Co.* v. *Higgins*, 157 F. 2d 884, 885 (C.A. 2d), certiorari denied, 330 U.S. 843. Neither does he avoid the realization impact of the "claim of right" rationale by alternatively claiming (Br. 14) to have received the stock as a bailee. This contention ignores the basic fact that the issue is not whether taxpayer realized income on the receipt of the stock but whether the taxpayer realized income on the sale. In any event, where, as here, the facts of a particular case support the applicability of the "claim of right" doctrine, the bailment contention will not serve as a bar. *United States* v. *Iozia*, 104 F. Supp. 846 (S.D. N.Y.).

Taxpayer's remaining contention (Br. 11-22) amounts, at most, to nothing more than an inconclusive attempt to obviate the clear applicability of the "claim of right" doctrine to the established facts here obtaining. Point II (a) (Br. 11-13) contributes nothing to advance taxpayer's general contentions. On the contrary, the utter failure to relate the discussion to the facts here obtaining deprives the argument of all force whatsoever. To the extent that tax-

payer exclusively emphasizes (Br. 11) the criterion of *when* income becomes taxable the focus is erroneously directed away from the here pertinent consideration that the "claim of right" rule becomes operative, under the instant facts, to product a realization of income in the year of taxpayer's receipt of the sales proceeds without restriction as to use. Clearly, this absence of restriction at the time of receipt, in 1951, is sufficient to make the rule operative, with the result that the sales proceeds are properly includible in gross income at that time. The correctness of this proposition is understood when attention is directed to the equally fallacious argument advanced by the taxpayer in Point II (c) (Br. 20-22) with respect to an alleged debtor-creditor relationship (Br. 20). Unlike the situation of a loan or a security deposit, the parties to the alleged promotional services agreement (R. 20) are in juxtaposition here with respect to raising a debtor-creditor analogy. Raichart had never advanced anything to the taxpayer which could have served to impose a use restriction on the stock sales proceeds when received by the taxpayer in 1951. Whereas the taxpayer relies upon the alleged breach (Br. 14), all that had been created by that agreement was, at most, a contractual relationship, which would not serve to prevent the applicability of the "claim of right" doctrine. As the court stated in *St. Regis Paper Co.* v. *Higgins*, *supra*, with respect to the dividends there in issue (p. 885):

> Their declaration violated no law and at most their payment was the breach of a private con-

> tract and the recipient was not without all semblance of right and title to them as was the embezzler in *Commissioner* v. *Wilcox*, 327 U.S. 404, 66 S. Ct. 546.

For purposes of taxability to the taxpayer in 1951, the fact that the contractual obligation ultimately proved enforceable is here irrelevant, and, in such circumstance, the taxpayer would, of course, become entitled to a deduction in the year of payment. What is relevant, for present purposes, is that the taxpayer actually did receive the sales proceeds without restriction in 1951 and treated them as his own and when a later claim was asserted by Raichart's estate he denied such claim and vigorously opposed it in the state courts. At no time, until appeal was finally denied did he recognize the claim's validity. In point of fact all that he ever recognized was the validity of the adverse judgment.

Point II (b) of taxpayer's argument (Br. 13-19), amounts essentially to a denial (Br. 14, 19) of any bona fide claim of right. But see *Rutkin* v. *United States*, *supra*. In making the contention the taxpayer basically alleges (Br. 14) the breach of the written agreement, which, as we have pointed out above, has, under the facts here established, no controlling effect. What is pertinent is that, at the time of the 1951 sale, the taxpayer received the sales proceeds, under a claim of right without restriction as to their immediate use. As between the California Corporation Commissioner and the taxpayer, no lawful restriction was further imposed when the shares were released from escrow. As between Raichart's

estate and the taxpayer, absent the assertion of any claim at the time of sale, the existence of an earlier executed private contract, which might or might not be raised and, if so, enforced, did not serve as a restriction upon immediate use. In point of fact, the taxpayer did receive the sales proceeds as his own and, subsequently, when the alleged breach was raised, did assert his claim to the proceeds in the courts. Not until the adverse judgment was rendered against him, in 1953, with appeal being denied, did he abandon his claim. Only in the sense that any losing litigant's claim, no matter how vigorously asserted, can be said to lack bona fides can it be said that the taxpayer's present contention has any validity and, to assert this proposition, would be to deny the operative effect of the claim of right doctrine altogether. Cf. *United States* v. *Lewis*, 340 U.S. 590, 592. Finally, the taxpayer's assertion of an equitable defense (Br. 14) is of no avail. As the Supreme Court majority stated in the *Lewis* case, *supra* (p. 592):

> The "claim of right" interpretation of the tax laws has long been used to give finality to that [annual account] period, and is now deeply rooted in the federal tax system. * * * We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.

CONCLUSION

The decisions of the Tax Court should be affirmed.

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